Supreme Court, U.S.
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No. 95-1966

In the Supreme Court of the United States

OCTOBER TERM, 1995

PAUL RUSSO, ET AL., PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

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20 pp

QUESTION PRESENTED

Whether petitioners' scheme to deceive public investors by buying and holding large blocks of certain stocks so as to create an appearance of active trading in those stocks and thereby prop up their market price, financed by false cash credits generated through fraudulent short sales of other securities, constituted illegal securities manipulation, in violation of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Rule 10b-5, 17 C.F.R. 240.10b-5.

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OPINION BELOW

The opinion of the court of appeals (Pet. App. A1-A30) is reported at 74 F.3d 1383.

JURISDICTION

The judgment of the court of appeals was entered on January 11, 1996. The petition for a writ of certiorari was filed on April 8, 1996. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

After a jury trial in the United States District Court for the Eastern District of New York, petitioners Russo and Hosman were each convicted on one count of conspiracy to commit securities fraud, in violation of 18 U.S.C. 371, 16 counts of mail fraud, in

violation of 18 U.S.C. 1341, and two counts of securities fraud, in violation of 15 U.S.C. 78j(b) and 78ff. Petitioner Petrokansky was convicted on five counts of mail fraud, in violation of 18 U.S.C. 1341, and two counts of securities fraud, in violation of 15 U.S.C. 78j(b) and 78ff.[1] Russo was sentenced to 18 months' imprisonment, to be followed by five years' probation, and was ordered to make restitution in an amount yet to be determined. Hosman was sentenced to five years' imprisonment (with all but six months suspended), to be followed by five years' probation. Petrokansky was sentenced to 12 months' imprisonment, to be followed by five years' probation. Pet. App. A2-A3, A9-A11.

1. Russo was the owner and president of Kureen & Cooper (K&C), a penny stock broker-dealer that he acquired after another broker-dealer firm that he owned went out of business due to insufficient minimum capital. Hosman was a long-time Russo associate who had moved to K&C from Russo's previous firm. She served as a K&C director, managed the K&C office, and worked as a K&C broker. Petrokansky also came to K&C from Russo's previous firm. He was one of roughly twenty stock salesmen working at K&C but, unlike the other salespeople, he had his own office and reported directly to Russo rather than to the manager in charge of the brokers. Pet. App. A3-A4.

The charges against petitioners arose from their scheme to manipulate the market price of the securities of two start-up companies, Lopat Industries, Inc. (Lopat), and E.A.S. Technologies, Inc. (EAS). K&C

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[1] A mistrial was declared as to the remaining counts against Petrokansky. Pet. App. A11.

had underwritten the initial public offerings of both companies and, as part of its compensation, had received warrants entitling it to buy large numbers of the companies' shares at predetermined prices after one year. The warrants gave K&C an incentive to establish markets for the stocks so that the price of the companies' shares might rise above the exercise prices set by the warrants. Once trading began, K&C acted as the principal market maker for both companies' securities in the over-the-counter market, holding itself out as ready to buy and sell Lopat and EAS stocks at prices posted on the National Association of Securities Dealer Automated Quotation system. Pet. App. A-4, A-17.

The companies' stocks did not perform well. By August 1986, there were more customers seeking to sell the stocks than to buy them. K&C was itself so thinly capitalized, moreover, that it had to sell whatever shares it took in as market maker by the end of each day in order to maintain the minimum net capital required by the Securities and Exchange Commission's broker-dealer regulations. Given the low demand for the companies' securities, K&C was faced with the prospect of having to sell off the shares that it acquired each day at reduced prices, which would further reduce their market value. To forestall that possibility, petitioners embarked on a scheme, from July through December, 1986, to purchase and hold large blocks of Lopat and EAS stock in order to create the false impression that the stocks were being actively traded by the public and among other dealers, and thereby prop up the stocks' market prices. Pet. App. A5-A6.

As charged, petitioners' scheme had three deceptive components:

a. Acting on Russo's instructions, Hosman placed blocks of the companies' stocks, totalling hundreds of thousands of shares, in K&C customer accounts without the customers' authorization, which made it seem as though the stocks were more actively traded than they were. When a customer discovered the improper placement, K&C would take the shares back (often simply to place them in another customer's account), but during the term of their improper placement the shares were off the market, which reduced further erosion in their market prices. Pet. App. A6-A7.

b. Also on Russo's instructions, Petrokansky placed substantial blocks of the companies' stocks with certain customers on the understanding that K&C would buy the shares back in a week or two at a guaranteed small profit to the customer. Like the unauthorized placements, "parking" the stocks with K&C customers had the effect of taking large quantities of shares off the market. Pet. App. A7.

c. Russo obtained the means to finance K&C's substantial purchases of Lopat and EAS stocks, and to pay a profit margin to those with whom K&C parked blocks of the companies' shares, by making fraudulent short sales of other securities to its clearing firm, Evans, Inc. Pet. App. A7-A9.[2] Securities and Ex-

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[2] A short sale is a sale of stock that the seller does not own. At the time of the sale, the seller delivers borrowed stock. Eventually, the seller must "cover" the sale by purchasing stock to return the shares it has borrowed. A short seller profits from any interim decline in the market price of the stock, capturing the difference between the original sale price and the cover price. *United States* v. *Naftalin*, 441 U.S. 768, 770 (1979).

change Commission (SEC) regulations require a short seller to put up a margin equal to at least 50% of the value of the stock sold, and require that any proceeds from the short sale be frozen until the seller has covered its position. 12 C.F.R. 220.19(a). Russo became aware, however, that, because of a glitch in Evans' accounting system, so long as K&C did not notify Evans (as it was required to do by the clearing agreement) that the sales it was making were short sales, Evans would immediately credit K&C's account with the proceeds of those sales, without requiring the posting of margin or waiting until the position was covered. Pet. App. A8. By effecting short sales without notice to Evans, K&C was therefore able to receive an unrestricted cash credit in its account for each short sale made. *Ibid.* Russo ultimately used those cash credits to finance K&C's acquisition of more than 800,000 shares of Lopat and EAS stock—thus keeping in K&C's inventory a large volume of stocks that would otherwise have been sold at a loss on the open market—and to pay the profit margins promised to K&C customers for parking the companies' shares. *Id.* at A9.

The three components of petitioners' scheme thus operated together to permit K&C to balance out its trading account each day during the fall of 1986 while at the same time artificially boosting the price of the companies' stocks. Pet. App. A9. In December 1986, however, Evans discovered the improper short selling and cancelled its clearing agreement with K&C. *Ibid.* When petitioners' scheme collapsed, the prices of the

stocks plummeted,[3] and K&C went out of business. *Ibid.*[4]

2. The court of appeals rejected (Pet. App. A11-A18) petitioners' argument that the fraudulent short sales were insufficiently connected to K&C's purchases of Lopat and EAS stocks to be considered part of petitioners' manipulative scheme under Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act), 15 U.S.C. 78j(b), and Rule 10b-5, 17 C.F.R. 240.10b-5.[5] The court explained that petitioners had operated a "stock-kiting scheme," in which they moved the companies' stocks from account to account to create the appearance of an active market. Pet. App. A16. While their fraudulent short sales did not affect the markets for the stocks through actual trading,

> they enabled K&C to create a false impression of demand for the stock and to shield prices from the

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[3] Within two weeks, the price of Lopat and EAS shares dropped 42% and 59%, respectively, resulting in a loss of roughly $4 million in the combined value of the outstanding shares, and the prices continued to drop throughout the Spring of 1987. Pet. App. A10.

[4] Petitioners opened a new securities firm in the same office less than two weeks later. Pet. App. A10.

[5] Section 10(b) prohibits the use "in connection with the purchase or sale[ ] of any security" of "any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe." 15 U.S.C. 78j(b). Rule 10b-5, promulgated pursuant to Section 10(b), declares it unlawful (a) "to employ any device, scheme, or artifice to defraud," (b) to make material misrepresentations or misleading omissions, or (c) "to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security." 17 C.F.R. 240.10b-5.

> realities of the market. Without the money generated through the short sales, [petitioners] would not have been able to keep large blocks of Lopat and EAS off the market or finance the other elements of the kiting scheme, thereby misleading the public as to the value of Lopat and EAS stock.

Ibid. The court concluded that, unlike "an investor who lie[s] on a home loan application in order to get more money to buy stock," K&C could not, as the market maker, separate its fraudulent short sales from its purchases of Lopat and EAS stock. *Id.* at A16-A17.

The court of appeals also rejected (Pet. App. A17) petitioners' argument that their fraudulent short sales could not be considered part of the stock manipulation scheme absent proof that they breached an independent duty (arising from a fiduciary or similar relationship) to disclose their deceit to those in the market. In the court's view, petitioners' nondisclosure theory derived no support from *Chiarella* v. *United States*, 445 U.S. 222 (1980), because *Chiarella* was concerned with those who seek to benefit personally from insider trading, not with those, like petitioners, who seek to benefit from active manipulation of the market. Pet. App. A17.[6]

ARGUMENT

The court of appeals correctly affirmed petitioners' convictions under the facts of this case, and its decision does not conflict with any decision of this

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[6] The court also rejected a number of other challenges to petitioners' convictions, none of which is raised in the petition.

Court or of any other court of appeals. No further review is warranted.

1. Contrary to petitioners' argument (Pet. 20), stock purchases made for the purpose of artificially manipulating the market are a form of fraud actionable under the securities laws. Congress passed the Exchange Act in order to "insure the maintenance of fair and honest markets" in securities transactions. 15 U.S.C. 78b. Schemes to affect market prices were of particular concern, because, as Congress recognized, "the prices of securities on [securities] exchanges and [over-the-counter] markets [we]re susceptible to manipulation and control." 15 U.S.C. 78b(3). Section 10(b) of the Exchange Act thus prohibits the use, "in connection with the purchase or sale of any security," of "any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe." 15 U.S.C. 78j(b). It is implemented by Rule 10b-5, which, among other things, declares it unlawful, "in connection with the purchase or sale of any security," for any person to "employ any device, scheme, or artifice to defraud" or "engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person." 17 C.F.R. 240.10b-5.

As used in Section 10(b), "manipulative" is a term of art that "connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities." *Schreiber* v. *Burlington Northern, Inc.*, 472 U.S. 1, 6 (1985), quoting *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 199 (1976) (emphasis omitted). "The term refers generally to practices, such as wash sales, matched orders, or rigged prices, that are

intended to mislead investors by artificially affecting market activity." *Schreiber*, 472 U.S. at 6, quoting *Santa Fe Industries, Inc.* v. *Green*, 430 U.S. 462, 476-477 (1977). It is understood to encompass "the full range of ingenious devices that might be used to manipulate securities prices." *Schreiber*, 472 U.S. at 7, quoting *Green*, 430 U.S. at 477.

Unlawful manipulation is not limited to misleading statements, but also includes conduct intended fraudulently to influence the market price of securities. As Lord Lopes observed more than one hundred years ago, with regard to securities fraud, there is "no substantial distinction between false rumours and false and fictitious acts." *Scott* v. *Brown, Doering, McNab & Co.*, [1892] 2 Q.B. 724, 730 (Eng. C.A.) (quoted approvingly in *Schreiber*, 472 U.S. at 7 n.4). Indeed, "the highest type of representation which can be made to the market is the representation contained in the published report of a sale," because a reported sale price "constitutes an open representation to the market of an appraisal at which one party has been willing to sell and another party willing to buy; it promptly becomes an element of every subsequent appraisal, at least for a period of time." Adolph A. Berle, Jr., *Liability for Stock Market Manipulation*, 31 Colum. L. Rev. 264, 270-271 (1931). It has thus long been recognized that stock trades made without verbal misrepresentations, but executed for the purpose of manipulating the stock price, are a form of actionable fraud.[7]

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[7] See *Halsey, Stuart & Co.*, 30 S.E.C. 106, 112 (1949) (trades made for the purpose of manipulating stock prices are prohibited by Rule 10b-5, because their effect "is to distort the character of the market as a reflection of the combined judg-

Petitioners' actions fall squarely within that category of prohibited conduct. Over the course of nearly six months, petitioners operated what the court of appeals aptly described as a stock-kiting scheme. In the guise of making a market, petitioners bought Lopat and EAS stocks into K&C's inventory in order to create the false appearance of substantial market demand and, at the same time, reduce the supply of those stocks on the market. Because K&C could not afford to hold the stocks, and could not sell them without causing the market price to collapse, petitioners made unauthorized placements of shares into its customers' accounts and parked blocks of shares in other customers' accounts, constantly shuffling the stocks among various accounts to escape detection. Their fraudulent short sales of other securities generated the cash credits that petitioners needed to acquire the stocks and to pay the customers' parking commissions. The purpose and effect of petitioners' scheme was to deceive investors as to the true market value of Lopat and EAS securities. The magnitude of their deception was illustrated by the fact that, when petitioners found

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ments of buyers and sellers, and to make of it a stage managed performance."); see also, *e.g.*, *Pagel, Inc.* v. *SEC*, 803 F.2d 942, 945-946 (8th Cir. 1986); *Alabama Farm Bureau Mut. Cas. Co.* v. *American Fidelity Life Ins. Co.*, 606 F.2d 602, 611-613 (5th Cir. 1979), cert. denied, 449 U.S. 820 (1980); *United States* v. *Charnay*, 537 F.2d 341, 347-351 (9th Cir.), cert. denied, 429 U.S. 1000 (1976); *Schlick* v. *Penn-Dixie Cement Corp.*, 507 F.2d 374, 379 (2d Cir. 1974), cert. denied, 421 U.S. 976 (1975). See also *Landy* v. *FDIC*, 486 F.2d 139, 161 (3d Cir. 1973) ("scheme deliberately calculated to manipulate the market value of a stock" is covered by Rule 10b-5), cert. denied, 416 U.S. 960 (1974).

themselves unable to continue the scheme, the market price of the companies' stocks fell by more than 40%. Pet. App. A10.

2. Petitioners contend (Pet. 9-18) that the short sales, though fraudulent, were not effected "in connection with" the manipulative purchases so as to implicate Section 10(b), and that, since there is a possibility that the short sales were the only deceptive conduct found by the jury, their convictions must be reversed. They argue (Pet. 8-9) that the court of appeals' interpretation of Section 10(b) exposes all securities traders to liability "whenever their open-market purchases are said to be funded by any fraud on anyone in any context." That argument is without merit.

a. The court of appeals' decision, which turned on the special facts presented by petitioners' scheme, was correct on those facts, and in no sense suggests that "any fraud" by a securities purchaser "in any context" is a sufficient basis for conviction of securities fraud. The court was careful to explain that it was not merely the fact that K&C's purchases happened to be funded by the proceeds of the short sales that rendered the short sales sufficiently "in connection with" the manipulative scheme. The decision below turned on the fact that the short sales were an integral part of a multi-faceted scheme by the principal market maker to deceive investors as to the value of Lopat and EAS stocks. Through petitioners' actions, K&C used one part of its business as a securities dealer (the fraudulent short selling) to operate another part of its business (maintenance of a market for the manipulated securities). Because K&C was the principal, indeed the dominant, market maker in Lopat and EAS stock, "there was no 'open market' on

which [K&C] could trade except for the one it created, and it could not have continued to make this market without the money generated by the short sales." Pet. App. A17.

Investors have the right, when they trade in securities, to expect that the market is a real one, not a sham fabricated by the market maker through artificial trades made with false cash credits. In this case, investors who traded in the manipulated stocks were injured "as a result of deceptive practices touching [on their purchase or] sale of [the securities]," and that satisfies the "in connection with" requirement. See *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 404 U.S. 6, 12-13 (1971).[8]

b. Contrary to petitioners' argument (Pet. 11-13), the decision in this case does not conflict with the decisions of other courts of appeals concerning the scope of the "in connection with" requirement. None of the purportedly conflicting cases cited by petitioners involved facts analogous to those here. *Gurwara* v. *Lyphomed, Inc.*, 937 F.2d 380 (7th Cir. 1991), concerned a misrepresentation by an employer that stock options it had granted an employee would not be affected by a change in his employment status. The court held that the misrepresentation was not actionable under Section 10(b), because "the misrepresentation went only to [the employee's] opportunity to purchase the stock at the described price" and was "in

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[8] The indictment, moreover, independently charged that petitioners Russo and Hosman conspired to deceive Evans through the short selling, in violation of the mail fraud statute. See *Naftalin*, 441 U.S. at 772-777 (fraud against a broker-dealer by its customer is a violation of the federal securities laws).

no way related to the value of that stock." *Id.* at 382-383. *Hunt* v. *Robinson*, 852 F.2d 786 (4th Cir. 1988), involved a claim by an employee that his employer fraudulently refused to convey to him stock that he had been promised in consideration for his labor. The court found that the alleged fraud was outside the scope of the securities laws, because it lay "not in the actual sale of the stock, but in defendants' refusal to tender the shares as required by the terms of the contract." *Id.* at 787. *Chemical Bank* v. *Arthur Anderson & Co.*, 726 F.2d 930 (2d Cir.), cert. denied, 469 U.S. 884 (1984), concerned a loan that had been extended on the basis of fraudulent financial statements submitted by the borrower. Although the loan was secured in part by stock of the borrower's subsidiary, no misrepresentations had been made with regard to the pledged stock, and the court held that the fraudulent financial statements were not sufficiently related to the pledge to bring the pledge within Rule 10b-5. *Id.* at 943.[9]

In contrast to those cases, in this case petitioners' fraudulent short sales were directly related to their scheme to manipulate the market price of securities. K&C's acquisition of large blocks of Lopat and EAS stocks with false cash credits generated by the unauthorized short sales was designed to create a false impression of a robust and healthy market for the shares—and thus to deceive participants in the market for securities (the very persons Section 10(b) was enacted to protect). Cf. *Bankers Life*, 404 U.S.

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[9] Even if there were tension between the decision in *Chemical Bank* and the decision in this case, a conflict within a court of appeals is properly resolved by that court. *Wisniewski* v. *United States*, 353 U.S. 901, 902 (1957) (per curiam).

at 6, 9 (misrepresentation respecting value of consideration paid for stock is a form of securities fraud).[10]

c. Petitioners claim (Pet. 15-16) that this case reflects a "general tendency" on the part of the Second Circuit to give a broad construction to Section 10(b)'s "in connection with" requirement. They contend that review should be granted here in light of disagreement in the circuits with respect to the validity of the misappropriation theory of insider trading, which also involves the scope of the "in connection with" requirement. See *United States* v. *O'Hagan*, Nos. 94-3856 & 94-3714, 1996 WL 431180 (8th Cir. Aug. 2, 1996) (finding the misappropriation theory invalid; discussing cases). The issues in those cases are (i) whether actionable misappropriation requires proof of deceptive conduct, and (ii) whether, when the person to whom a fiduciary duty not to trade on inside information is owed is neither the issuer nor a party to the transaction, a breach of that duty is, as Section 10(b) requires, "in connection with the purchase or sale" of securities. Those issues are not implicated here, because petitioners unquestionably engaged in deceptive conduct, and their victims indisputably included traders in the manipulated stocks. The validity of the misappropriation theory of insider trading has no bearing on the circumstances presented in this case.

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[10] Although petitioners also cite *Angelastro* v. *Prudential-Bache Securities Inc.*, 764 F.2d 939 (3d Cir.), cert. denied, 474 U.S. 935 (1985), in that case the court affirmed the district court's finding that misrepresentations by a broker-dealer concerning the interest charged on a margin account constituted fraud in connection with the purchase or sale of securities, even though the misrepresentations did not relate to the value of the security or the consideration offered for it. *Id.* at 944.

3. Contrary to petitioners' argument (Pet. 18), the court of appeals did not hold that petitioners "breached a duty to the entire market to make a general disclosure of their deceit on Evans." Rather, the court correctly rejected petitioners' claim that, in addition to proving petitioners' implementation of a scheme to artificially maintain the market price of Lopat and EAS stocks, the government was required to prove that petitioners breached a fiduciary or similar duty to those in the market by failing to disclose their unlawful manipulation.

Proof of an independent duty to disclose is required in prosecutions, like that in *Chiarella*, that are based on a defendant's failure to disclose non-public information on which he has traded. Petitioners' convictions were based on an entirely different form of misrepresentation—artificial trading designed to deceive public investors into believing that the demand for and the market price of the stocks were higher than they actually were. Petitioners' scheme entailed a failure to disclose their manipulative conduct,[11] but petitioners' "false and fictitious acts" of manipulation (*Schreiber*, 472 U.S. at 7 n.4) were the core of the scheme and the basis of petitioners' convictions. Regardless of whether a person has a relationship that gives rise to a duty to make disclosure, he has a duty not to engage in affirmative acts of deception. See *Basic Inc.* v. *Levinson*, 485 U.S. 224, 240 n.18 (1988) (even those who have no duty to disclose are "under the ever-present duty not to mislead"); *Green*, 430 U.S. at 476 ("manipulation" includes "practices, such as wash sales, matched

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[11] "Indeed, nondisclosure is usually essential to the success of a manipulative scheme." *Schreiber*, 472 U.S. at 7.

orders, *or rigged prices*, that are intended to mislead investors by artificially affecting market activity") (emphasis added).

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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